STATE OF TENNESSEE

DEPARTMENT OF COMMERCE AND INSURANCE

REPORT ON EXAMINATION

OF

PREFERRED AUTO INSURANCE COMPANY, INC.

(NAIC # 10223)

MEMPHIS, TENNESSEE

AS OF

DECEMBER 31, 2012

EXHIBIT

"A"

TABLE OF CONTENTS

Introduction 1
Scope of Examination 1
Compliance with Previous Examination Findings 2
Company History 3
Management and Control 4
  Management 4
  Conflicts of Interest and Pecuniary Interest 5
  Corporate Records 5
  Control 5
  Organizational Chart 6
Management and Service Contracts 6
Fidelity Bond and Other Insurance 8
Retirement Plans and Other Employee Benefits 8
Territory and Plan of Operation 8
Growth of Company 9
Loss Experience 9
Reinsurance Agreement 9
Commitments and Contingent Liabilities 10
Statutory Deposits 11
Accounts and Records 11
Market Conduct Activities 12
Financial Statements 13
  Assets 13
  Liabilities, Surplus and Other Funds 14
  Statement of Revenues and Expenses 15
  Capital and Surplus Account 15
  Reconciliation of Capital and Surplus 16
Summary of Significant Findings 17
Analysis of Changes in Financial Statements 17

Comments and Recommendations......17
Subsequent Events......17
Conclusion......18
Affidavit......19

Memphis, Tennessee
February 14, 2014

The Honorable Julie Mix McPeak
Commissioner
Tennessee Department of Commerce and Insurance
500 James Robertson Parkway
Nashville, Tennessee 37243

Dear Commissioner:

Pursuant to your instructions and in accordance with Tenn. Code Ann. § 56-1-408, regulations, and resolutions adopted by the National Association of Insurance Commissioners (NAIC), a full-scope financial examination and market conduct review has been made concerning the conditions and affairs of:

PREFERRED AUTO INSURANCE COMPANY, INC.
NAIC # 10223
216 South Cooper
Memphis, Tennessee 38104

hereinafter generally referred to as the "Company" and a report thereon is submitted as follows:

INTRODUCTION

This examination was called by the Commissioner of the Tennessee Department of Commerce and Insurance (TDCI) and commenced on February 11, 2013 and was conducted by duly authorized representatives of the TDCI under the association plan of the NAIC.

SCOPE OF EXAMINATION

The last examination of the Company was completed as of December 31, 2007. This examination report covers the period from January 1, 2008 through December 31, 2012, and includes any material transactions and/or events occurring subsequent to the examination date and noted during the course of the examination.

The examination was conducted in accordance with the NAIC *Financial Condition Examiners Handbook* (Handbook) and practices and procedures of the TDCI.

The examination was planned to evaluate the financial condition and identify prospective risks of the Company by obtaining information about the Company, including corporate governance, identifying and assessing inherent risks within the company, and evaluating system controls and procedures used to mitigate those risks. The examination also included assessing the principles used and significant estimates made by management, as well as evaluation of the overall financial statement presentation, management's compliance with Statutory Accounting Principles and annual statement instructions, when consistent with Tennessee statutes and regulations.

COMPLIANCE WITH PREVIOUS EXAMINATION FINDINGS

Our examination included a review to determine the current status of the comments and recommendations in the previous Report on Examination dated June 5, 2009, which covered the period from December 31, 2002, through December 31, 2007.

- The Company improperly reported, in its 2007 Annual Statement, three certificates of deposit on Schedule E, Part 1. The three certificates of deposit have a fixed schedule of payments and a maturity date in excess of one year from the date of acquisition. This classifies as a bond under Statement of Statutory Accounting Principles No. 26.

  It is recommended that the Company properly reflect the certificates of deposit in Schedule D and as Bonds on the Annual Statement Asset page 2 to better comply with SSAP No. 26 and Tenn. Code Ann. § 56-1-501(g) when completing the Annual Statement.

- The Company did not produce minutes for 2003 and 2004. Minutes for 2005 – 2007 were reviewed. Minutes did not reflect an annual meeting as stated in the by-laws. All meetings were recorded as regular meetings. The minutes did not reflect election of directors and officers as stated in the Company's by-laws. The minutes did not have consistent approval of professionals (auditor, actuary) retained by the Company.

  It is recommended that the Company comply with Tenn. Code Ann. § 56-2-103(a)(2) by holding annual meetings as required by Tenn. Code Ann. § 48-17-101(a), electing officers as required by Tenn. Code Ann. § 48-18-103(d), and maintaining corporate records as required by Tenn. Code Ann. § 48-26-101(a).

- The following inaccuracies were reported on the Company's 2007 Annual Statement:

    1) The Company's Jurat page does not include Charles L. Kelley as a director. Mr. Kelley is a member of the board of directors.

    2) On the Company's Schedule D, Part 1, the bonds are being reported on the settlement date instead of the trade date. In accordance with SSAP No. 26, paragraph 4, the Company should report bond transactions on the trade date and not the settlement date.

    3) On the Company's Schedule D, Part 1, the bonds are being shown having an accretion. These amounts are amortizations. The Company should properly reflect these amounts in the Annual Statement.

    4) On the Company's Schedule D, Part 1, the bonds are being reported with NAIC designations of 1. The designation should be reported as 1FE.

    5) The due and accrued interest on Schedule E – Part 1 is misreported. The Company should report the amounts accurately. The amount was deemed immaterial, resulting in no change to the financial statements.

    Based on the above inaccuracies, it is recommended that the Company comply with Tenn. Code Ann. § 56-1-501(g) by preparing annual statements in accordance with the NAIC Accounting Practices and Procedures Manual.

It was determined that the Company has addressed and taken action to comply with the findings of the previous examination report.

COMPANY HISTORY

General

The Company was incorporated on April 27, 2000, under the Tennessee Business Corporation Act as a for-profit corporation authorized to transact business in the State of Tennessee.

The Company was issued a certificate of authority dated January 16, 2001, from the State of Tennessee Department of Commerce and Insurance to transact the business of property, casualty, and vehicle insurance.

As of December 31, 2012, owners' shares and percentages were:

Name	Number of Shares	Percentage
Jeffrey L. Kelley	357,142.85	35.72%
Vincent G. Kelley	285,714.29	28.57%
Clinton B. Haley	285,714.29	28.57%
Danny W. Lazenby	71,428.57	7.14%
Totals	1,000,000.00	100.00%

As of December 31, 2012, the Company was licensed only in Tennessee.

Dividends

In 2008 and in 2009, the Company paid ordinary dividends in the amounts of $280,000 and $140,000, respectively, pursuant to Tenn. Code Ann. § 56-11-105(e).

MANAGEMENT AND CONTROL

MANAGEMENT

The business and affairs of the Company were managed by a Board of Directors composed of four (4) individuals.

The following individuals were serving as Directors on December 31, 2012:

Name	Title/Position
Jeffrey L. Kelley	Owner, President and CEO
Clinton B. Haley	Owner, Vice President and CFO
Vincent G. Kelley	Owner, Vice President
Danny W. Lazenby	Owner, Vice President

The 2012 annual meeting of the Company was held in accordance with Tennessee statutes.

The officers of the Company included a President, Secretary, and Treasurer as determined by the Board of Directors.

The following individuals were serving as Officers on December 31, 2012:

Name	Title/Position
Jeffrey L. Kelley	President
Vincent B. Kelley	Secretary/Treasurer
Clinton B. Haley	Vice President
Danny W. Lazenby	Vice President

The following committees were appointed by the Board of Directors and serving as follows:

Audit Committee	**Finance Committee**
Jeffrey L. Kelley	Jeffrey L. Kelley
Clinton B. Haley	Vincent G. Kelley
Max L. Jones	Clinton B. Haley

CONFLICTS OF INTEREST AND PECUNIARY INTEREST

Directors and officers of the Company completed an Executive Disclosure Form for Conflicts of Interests annually. The disclosure forms were reviewed without exception.

A review of compliance with Tenn. Code Ann. § 56-3-103 found that no director or officer of the Company had a pecuniary interest in the investment or disposition of Company funds.

CORPORATE RECORDS

The Charter and the Bylaws were not amended during the period covered by the examination.

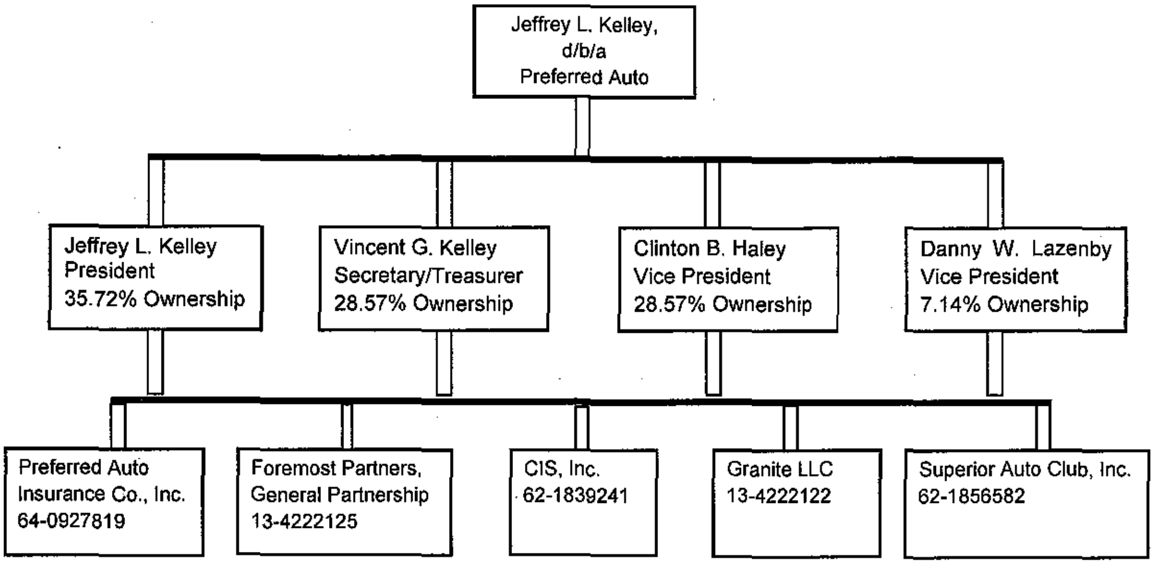
The recorded minutes of the Board of Directors were reviewed for the period under examination. The minutes of meetings were found to be adequate in detail to support the actions of the Company.

The Board of Directors approved investment transactions for the period under review.

CONTROL

As of December 31, 2012, the owners maintained 100% control of the Company.

ORGANIZATIONAL CHART



Ownership in each subsidiary company is distributed as shown in the organizational chart above.

MANAGEMENT AND SERVICE CONTRACTS

The Company is a member of an insurance holding company system as defined by Tenn. Code Ann. § 56-11-101 (2008) and is subject to Tenn. Code Ann. § 56-11-101 (2008), *et seq.* "Insurance Holding Company System Act of 1986." The Company files a Holding Company Registration Statement annually as required by Tenn. Code Ann. § 56-11-105. The required Forms B and C were filed April 25, 2013.

The owners of the Company own the affiliates of Granite, LLC, Foremost Partnership, and Corporate Insurance Services, Inc. which have agreements with the Company as follows:

- Granite, LLC has a general agency agreement with the Company with an effective date of October 1, 2003. This agreement permits the Agency to collect and receive premiums on insurance contracts placed with the Insurer by the Agency. The Agency is granted authority to receive and submit applications and proposals for automobile policies in any jurisdiction where the Agency is properly licensed and where the Company has confirmed with the state insurance department that the Agency is the Company's insurance agent. The commission rate for all business is set by the contract. The Company filed the agreement pursuant to Tenn. Code Ann. § 56-11-106 on July 14, 2003. The agreement was approved on September 9, 2004.

- Granite, LLC has a lease agreement with the Company for the use of web enabled software with an effective date of October 1, 2007. The software enables the Company to contract with independent agents, provide web based document imaging, receive applications from policyholders, track policies, and provide current information to independent agents. As of October 1, 2012, the monthly rate increased by ten percent (10%). The Company did not implement the new rate until February 1, 2013. The Company filed the agreement pursuant to Tenn. Code Ann. § 56-11-106 on August 24, 2007. The agreement was approved on October 3, 2007.

- The Company rents its home office building from Foremost Partnership under a lease agreement beginning July 1, 2007. The monthly rate is contracted to increase July 1 of each year. The Company has exercised its option to continue the lease agreement for five (5) one year periods, subsequent to the expiration of the initial lease. As of July 1, 2012, the monthly rate increased. The Company filed the agreement pursuant to Tenn. Code Ann. § 56-11-106 on April 18, 2007. The agreement was approved on May 15, 2007. The lease agreement was amended, effective July 1, 2013, with an option to continue for five (5) one year periods, subsequent to the expiration of the lease. The Company filed the amended agreement pursuant to Tenn. Code Ann. § 56-11-106 on April 30, 2013. The agreement was approved on May 29, 2013.

- Corporate Insurance Services, Inc. operates under an agreement, effective February 1, 2012, with the Company to provide claims administration services which include the following:

    - Basic claim service
    - Police reports
    - History of vehicle registration/clear title guarantee
    - NADA appraisal information
    - Car tag registration
    - Appraisals outside of Tennessee
    - Independent adjuster services
    - Claims research software and subscription
    - Special Investigative Unit

The Company pays a fee to Corporate Insurance Services, Inc. for claims adjuster services. The Company filed the agreement pursuant to Tenn. Code Ann. § 56-11-106 on December 27, 2011. The agreement was approved on January 31, 2012.

FIDELITY BOND AND OTHER INSURANCE

The Company maintains a $100,000 fidelity bond. The Handbook suggested a minimum coverage of $100,000 to $125,000.

RETIREMENT PLANS AND OTHER EMPLOYEE BENEFITS

As of December 31, 2012, the following benefits were available to the Company's employees through Granite, LLC (an affiliate of the Company):

401(k) Plan
The Company offers a defined contribution plan. Employees are eligible upon completing one (1) year of service. The Company matches dollar for dollar on the first three (3) percent and 50 cents on the dollar on the next two (2) percent. The plan is administered through CFH Financial.

Medical Coverage
Medical coverage is provided through optional participation in a Humana medical plan.

Long Term Disability, Etc.
Employees have Company paid disability insurance which pays an employee until age 65. Additional workplace insurance is offered, on the basis of voluntary participation, to each employee through the AFLAC/Assurant group of companies.

Education
The Company provides educational assistance to employees taking work related courses.

Other Benefits
The Company provides employees with paid holidays, sick leave, and vacation leave.

TERRITORY AND PLAN OF OPERATION

Territory
As of December 31, 2012, and as of the date of this examination report, the Company was licensed to transact business only in Tennessee. The Certificate of Authority was valid. On Schedule T of the 2012 Annual Statement for Tennessee, the Company reported writing direct premiums of $5,788,166.

Plan of Operation

The Company writes automobile liability and physical damage coverage for the non-standard market in Tennessee. The Company is approved to issue tenant fire policies.

GROWTH OF COMPANY

The following table depicts certain aspects of the growth and financial history of the Company during the examination period:

Year	Direct Premiums Written	Net Admitted Assets	Liabilities	Retained Earnings	Policyholder Surplus
2012	$5,788,166	$5,943,813	$3,295,533	$227,637	$2,648,280
2011	4,390,390	5,509,755	2,899,534	150,357	2,610,221
2010	4,254,445	5,984,744	3,445,787	74,685	2,538,958
2009	4,553,867	6,337,423	3,873,155	40,375	2,464,268
2008	4,904,887	6,768,926	4,186,968	200,375	2,581,958

LOSS EXPERIENCE

The loss experience of the Company during the examination period was as follows:

Year	Premiums Earned	Losses Incurred	LAE Incurred	Loss Ratio
2012	$1,915,222	$1,093,312	$679,678	92.6%
2011	1,581,259	809,629	382,520	75.4%
2010	1,596,477	780,320	495,980	79.9%
2009	1,530,959	795,785	474,189	83.0%
2008	$2,251,520	$1,256,378	$627,577	83.7%
Total	$8,875,437	$4,735,424	$2,659,944	83.3%

REINSURANCE AGREEMENT

Reinsurance Ceded

The Company entered into a quota share reinsurance agreement with Transatlantic Reinsurance Company, an authorized reinsurer, effective January 1, 2010. The agreement shall remain in effect unless notice is provided by one party to the other party to terminate the agreement. Addendum No. 1 was effective January 1, 2011, and adjusted the limits of liability and changed the intermediary. Addendum No. 2 was effective January 1, 2012, and changed the original conditions and adjusted the ceding commission. Addendum No. 3 was effective January 1, 2013, and adjusted the retention, ceding limit and ceding commission. Addendum No. 4 was retroactively effective to January 1, 2011, and again adjusted the retention and ceding limit. The Company ceded 70% of its gross written premium to the reinsurer. The reinsurer will not be liable for more than $1,000,000 for all losses incurred during a contract year resulting from Act(s) of Terrorism. Extra contractual obligations and loss in excess of policy limits shall be subject to a maximum limit of liability to the Reinsurer of $1,500,000 for all losses occurring during each contract year.

The reinsurance agreement does not require approval pursuant to Tenn. Code Ann. § 56-11-106. The reinsurance agreement contained acceptable provisions of reporting responsibility of the ceding entity, payment terms, premium taxes, termination clauses and ceding clauses. The Company's reinsurance agreements transferred risk in accordance with SSAP No. 62 and NAIC guidelines.

See also "Subsequent Events" later in this report.

The reinsurance agreement permits ceding commissions on the basis of earned ceded premiums. There is no unearned ceded premium.

COMMITMENTS AND CONTINGENT LIABILITIES

The Company was involved in certain legal matters resulting from normal operations. The outcome of such actions should not have a material effect on the financial position of the Company.

STATUTORY DEPOSITS

In compliance with Tenn. Code Ann. § 56-2-104, the Company maintained the following deposits with the TDCI as of December 31, 2012:

Description	Par Value	Book/Adjusted Carrying Value	Market Value
TN St Sch Bd Auth RFDG – Higher 5.000%, Due 5-1-14 Cusip # 880557E82	$150,000	$158,027	$159,294
Met Gov Nash & David Cnty TN 2.656%, Due 7-1-17 Cusip # 592090CN2	$100,000	$103,568	$104,176
Total special deposits held for the benefit of all policyholders	$250,000	$261,595	$263,470

ACCOUNTS AND RECORDS

During the course of the examination, tests and audit procedures were performed, including verification of postings, extensions and footings. General ledger trial balances were reconciled with the Annual Statements and trial balances for all 5 years.

Differences in various items were noted; however, none were considered to produce a material effect on surplus funds, as regards policyholders, either singly or in aggregate. Except as otherwise noted in this report, accounting records conformed to statutory accounting practices and procedures and reflected the operations and status of the Company during the examination period.

Independent accountant, Lee Watson, CPA, audited the Company's financial statements for the years ending December 31, 2010, through December 31, 2012. Zeal Financial Services audited the Company's financial statements for the years ending December 31, 2008, through December 31, 2009.

The Company's Risk-Based Capital Report is in compliance with Tenn. Code Ann. § 56-46-101, *et seq.*

The Company's primary books and records are located at 216 South Cooper, Memphis, TN 38104.

MARKET CONDUCT ACTIVITIES

Underwriting, Rates, and Policy Forms

The Company uses casualty rates developed by a combination of Company experience and industry data. Application files and underwriting standards of written policies were reviewed, with no exceptions noted. The Company maintains written underwriting procedures and a rating guide.

Complaints

The Company maintains a complaint log. Inquiries made to consumer services indicated no regulatory concerns with the Company during the period of examination.

Advertising

The advertising program consists of a Company website (www.paicinsurance.com) and advertising carried out by Granite, LLC, a Company affiliate, in the name of AutoPlan (a captive agency). AutoPlan advertises on television and in the Yellow Pages. Advertising practices were acceptable.

Claims Review

A review of open and closed claim files indicated that claims were being paid in accordance with policy provisions. Settlements were made promptly upon receipt of proper evidence of the Company's liability.

Privacy Policy

The Company maintained a written privacy policy in compliance with Tenn. Comp. R. & Regs. 0780-1-72-.06.

FINANCIAL STATEMENTS

A statement of assets, liabilities and statement of income as of December 31, 2012, together with a reconciliation of capital and surplus for the period under review, as established by this examination is as follows:

ASSETS

	Assets	Non-admitted Assets	Net Admitted Assets
Bonds	$ 261,595	$ 0	$ 261,595
Cash and short-term investments	4,241,740	0	4,241,740
Subtotals, cash and invested assets	4,503,335	0	4,503,335
Investment income due and accrued	8,713	0	8,713
Deferred premiums, agent's balances and installments booked, deferred and not yet due	1,058,648	0	1,058,648
Amount recoverable from reinsurers	333,947	0	333,947
Current federal and foreign income tax recoverable and interest thereon	1,170	0	1,170
Net deferred tax asset	38,000	0	38,000
Totals	$5,943,813	$ 0	$5,943,813

LIABILITIES, SURPLUS AND OTHER FUNDS

Losses		$ 666,658
Loss adjustment expenses		591,757
Taxes, licenses, and fees		9,027
Unearned premiums		485,107
Ceded reinsurance premiums payable (net of ceding commissions)		1,345,360
Payable to parent, subsidiaries, and affiliates		186,791
Aggregate write-ins for liabilities		10,833
Total liabilities		$3,295,533
Common capital stock	$1,000,000	
Gross paid-in and contributed surplus	1,381,583	
Unassigned funds (surplus)	266,697	
Surplus as regards policyholders		2,648,280
Total liabilities and surplus		$5,943,813

STATEMENT OF REVENUES AND EXPENSES

Underwriting Income		
Premiums earned		$1,915,222
Total revenues		$1,915,222
Deductions		
Losses incurred	$1,093,312	
Loss expenses incurred	679,678	
Other underwriting expenses incurred	611,146	
Total underwriting deductions	2,384,136	
Net underwriting gain (loss)		(468,914)
Investment Income		
Net investment income earned	149,243	
Net realized capital gains (losses)	0	
Net investment gain		149,243
Other Income		
Net gain or (loss) from agents' or premium balances charged off	0	
Aggregate write-ins for miscellaneous income	363,830	
Total other income		363,830
Net income or (loss) after capital gains tax and before federal and foreign income taxes		44,159
Federal and foreign income taxes incurred		5,100
Net income		$ 39,059

CAPITAL AND SURPLUS ACCOUNT

Surplus as regards policyholders, December 31 previous year		$2,610,221
Net income	39,059	
Change in net deferred income tax	(1,000)	
Change in non-admitted assets	0	
Change in surplus as regards policyholders for the year		38,059
Surplus as regards policyholders, December 31 current year		$2,648,280

RECONCILIATION OF CAPITAL AND SURPLUS

	2012	2011	2010	2009	2008
Surplus as regards policyholders, December 31, previous year	$2,610,221	$2,538,957	$2,464,268	$2,581,958	$2,864,626
Net income	39,059	78,264	82,689	42,310	(2,668)
Change in net unrealized capital gains or (losses)	0	0	0	0	0
Change in net deferred income tax	(1,000)	(7,000)	(8,000)	(20,000)	0
Change in non-admitted assets	0	0	0	0	0
Dividends to stockholders	0	0	0	(140,000)	(280,000)
Net change for the year	38,059	71,264	74,689	(117,690)	(282,668)
Surplus as regards policyholders, December 31, current year	$2,648,280	$2,610,221	$2,538,957	$2,464,268	$2,581,958

SUMMARY OF SIGNIFICANT FINDINGS

There were no material findings or exceptions noted during the examination.

ANALYSIS OF CHANGES IN FINANCIAL STATEMENTS

No schedule or comment is applicable.

COMMENTS AND RECOMMENDATIONS

Comments

At December 31, 2012, the Company's custodial agreement did not contain all provisions required by Tenn. Comp. R. & Reg. 0780-1-46-.02.

SUBSEQUENT EVENTS

The Company entered into a Custodial Agreement with the Bank of Fayette County effective May 1, 2013. The Company signed the agreement on April 25, 2013. The Bank of Fayette County signed the agreement on May 1, 2013.

The Company executed a Custodial Agreement with the Bank of Fayette County effective December 19, 2013. The agreement supersedes the Custodial Agreement effective May 1, 2013. The agreement was again revised and signed by the Company and the Bank of Fayette County on January 30, 2014.

The Company and The Bank of Fayette County executed a new Custodial Agreement on January 30, 2014, to comply with all provisions required by Tenn. Comp. R. & Reg. 0780-1-46-.02.

The Company and Transatlantic Reinsurance Company executed Addendum No. 3 and Addendum No. 4 to the reinsurance agreement. Addendum No. 3 increased the retention and limitation and adjusted the ceding commission effective January 1, 2013. The Company signed the addendum January 9, 2013. Transatlantic Reinsurance Company signed the addendum April 8, 2013. Addendum No. 4 increased the limitation on ceded written premium retroactively effective to January 1, 2011. The Company signed the addendum on July 9, 2013. Transatlantic Reinsurance Company signed the addendum on July 10, 2013.

CONCLUSION

The customary insurance examination practices and procedures, as established by the NAIC, were utilized in connection with the verification and valuation of assets and the determination of liabilities in the financial statement of this report.

The examiners determined that as of December 31, 2012, the Company had net admitted assets of $5,943,813 and liabilities, exclusive of capital, of $3,295,533. Thus, there existed for the additional protection of the policyholders, the amount of $2,648,280 in the form of special surplus funds, aggregate write-ins for other than special surplus funds, and unassigned funds (surplus).

The courteous cooperation of the officers of the Company and its employees extended during the course of the examination is hereby acknowledged.

In addition to the undersigned, Jerry Ehlers, of the contracting firm, Noble Consulting Service, Inc., Indianapolis, Indiana, and Wes Campbell, of the contracting actuarial firm, Lewis and Ellis, Inc., Richardson, Texas, participated in this examination.

Respectfully submitted,

Bryant Cummings

Bryant Cummings, CFE
Examiner-in-Charge
State of Tennessee

AFFIDAVIT

The undersigned deposes and says that he has duly executed the attached examination report of Preferred Auto Insurance Company dated February 14, 2014, and made as of December 31, 2012, on behalf of the Tennessee Department of Commerce and Insurance. Deponent further says he is familiar with such instrument and the contents thereof, and that the facts therein set forth are true to the best of his knowledge, information, and belief.

Bryant Cummings

Bryant Cummings, CFE
Examiner-in-Charge
State of Tennessee

State Tennessee

County Davidson

Subscribed to and sworn before me

this 16th day of June, 2014

Notary Helen W. Dorsey

My Commission Expires: 11/06/2017

HELEN W DORSEY
STATE
OF
TENNESSEE
NOTARY
PUBLIC
DAVIDSON COUNTY

PREFERRED AUTO INSURANCE CO.

6-20-14

Ms. E. Joy Little
Director of Financial Examinations
Tennessee Department of Commerce and Insurance
500 James Robertson Pkwy.
Nashville, TN 37243

RE: Preferred Auto Insurance Company, Inc. – Report of Examination

Dear Ms. Little:

We hereby acknowledge receipt of the final Report of Examination for PAIC. By signing below, we indicate acceptance of the report, as transmitted, and without rebuttal.

Sincerely,

J Kelley, president

Jeff Kelley
President, PAIC

EXHIBIT
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"B"

P.O. BOX 41017 • MEMPHIS, TN 38174 • PHONE (901) 328-2000 • FAX (901) 328-2099